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## **Minimum (Annual) Tax on Partnerships, Limited Liability Companies and S-Corporations**

**Prepared for the Citizens Finance Review Commission**

**by**

**Income Tax Research Committee  
Anne Mariucci, Chair**

**and**

### **Authors:**

**James Barash, Manager at KPMG LLP**

**Patrick Derdenger, Partner of Steptoe & Johnson LLP**

**Barbara Dickerson, Director at Deloitte & Touche LLP**

**David Downs, Principal Tax Analyst of Salt River Project**

**Amy Etzkorn, Assistant Vice President Tax of AdvancePCS**

**Karen Jacobs, Senior Economist of the Department of Revenue**

**Georganna Meyer, Chief Economist of the Department of Revenue**

**Dana Naimark, Assistant Director of the Children's Action Alliance**

**Susan Kimsey Smith, Esq. of Olsen-Smith, Ltd.**

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## 1. What it is:

Every domestic partnership including syndicates, groups, pools, joint ventures and limited liability companies classified as a partnership for federal tax purposes must file an Arizona Partnership Income Tax Return, Form 165.

Every foreign partnership (syndicates, groups, pools, joint ventures and limited liability companies classified as a partnership for federal tax purposes) doing business in the state of Arizona must file an Arizona Partnership Income Tax Return, Form 165.

Every S-corporation taxed under Subchapter S of the Internal Revenue Code and subject to the Arizona Income Tax Act of 1978 that engages in a trade or business or has income from the state must file an Arizona S Corporate Income Tax Return, Form 120S.

Limited liability companies (LLCs) are a creation of state law. LLCs are owned by members, who aren't personally liable for the LLC's debts or obligations. Under the "check-the-box" entity classification rules, if an LLC isn't mandatorily classified as a corporation, it may elect to be classified for tax purposes either as a partnership or as a corporation. If an LLC is characterized as a partnership for federal tax purposes, the limited liability company will offer the flow-through of tax attributes, as well as limited liability. The members will report their share of the partnership income in computing their individual tax liabilities. A single member LLC is an exception. A single member LLC that doesn't elect to be a corporation is treated as not having any entity status, i.e., it cannot be treated as a partnership. A single member LLC treated as a disregarded entity is not subject to filing a tax return.

An eligible corporation may elect to be taxed as an S-corporation. Pass-through of tax attributes and limited liability are available to S-corporations. An S-corporation is generally exempt from federal and Arizona corporate level income tax. Instead, the corporation's income, loss, deduction and credit are passed through to, and taken into account by, its shareholders in computing their individual tax liabilities. S-corporations are subject to many restrictions, including restrictions on the number and kind of shareholders, which do not apply to limited liability companies.

Some S-corporations may be subject to one or more of federal corporate-level taxes on recognized built-in gains, excess net passive income, LIFO recapture, capital gains attributable to certain substituted basis property, and recapture of investment credit (if S election was made before 1987).

Currently, partnerships do not pay tax on net income nor pay a minimum (annual) tax with the filing of the Arizona tax return. The tax return is informational in nature. The net income and activity of the partnership is reported proportionately to each partner who reports his or hers share of the income in their income tax returns.

S-corporations are subject to Arizona income tax only if they have income subject to tax at the corporate level on the federal Form 1120S. The tax is 6.968% of net income or a minimum of \$50. The S-corporation is subject to the \$50 minimum tax only if it has income subject to tax at the federal level. Most S-corporations do not have income subject to tax at the federal level and are

thus not subject to the minimum tax. The net income and activity of the S-corporation is reported proportionately to each shareholder who reports his or hers share of the income in their income tax returns.

The proposal before this commission is the applying of a minimum (annual) tax on partnerships and expanding the minimum tax to all S-corporations not already subject to the minimum tax. The minimum (annual) tax would be applied on annual income tax return filing.

## **2. How it would be administered:**

The minimum tax will be collected with the filing of the partnership and S-corporate income tax returns or the filing of an extension by the original due date of the return. The tax is transmitted either by check or electronic funds transfer to the State.

The administration process would be similar to the minimum tax applied to corporation tax returns, Form 120.

## **3. Impact on Existing Revenue Systems:**

The minimum tax will become an expense of the partnership and S-corporations. This will directly reduce net income reported proportionately to each partner or shareholder and other current revenue sources of individual and corporate income tax.

Income tax revenues flow into the state's general fund and are shared with cities and towns. An increase in revenue with a minimum (annual) tax on partnerships and S-corporations, will increase the shared revenue to the cities and towns.

## **4. Cost:**

There will be a cost of administering the minimum partnership tax because the mechanisms for collecting and processing the tax are not already in place. The mechanisms could be mirrored after the C-corporate minimum tax. Tax return forms will need to be redesigned to accommodate a line for tax. Instruction changes and education of a new tax would also need to be made. The Department of Revenue's computer system may need to be modified to track, process and administer tax of a partnership.

We believe the compliance cost to partnership taxpayers would be small for preparing and remitting the funds.

S-corporate minimum tax already exists for those that have income that is subject to tax at the federal level. This can be expanded to include all S-corporations. The cost would be minimal.

We believe the compliance cost to S-corporate taxpayers would be nominal as a minimum tax is in existence and the preparing and remitting processes remain the same.

Should Arizona deviate from the federal approach, the cost to administer the tax and the cost for the taxpayer to comply could increase significantly.

**5. Policy Considerations:**

**A. Equity**

A minimum tax is evenly applied across all entities filing a partnership and S-corporate returns (that were not previously subject to the minimum tax) in horizontal equity. Single member LLC's treated as disregarded entities are not required to file a return and would not be subject to the minimum tax.

The tax is regressive for vertical equity where taxpayers regardless of income or loss pay the same rate.

A minimum tax on pass-through entities creates double taxation – once through the minimum tax and once again on the partner's, member's or shareholder's return. This is a departure from the pass-through concept.

**B. Economic Vitality**

California is the only state among the 10 comparison states to apply a minimum (annual) partnership tax. The annual tax is \$800 and is applied to partnerships that are doing business, registered, or organized in the state. The tax cannot be deducted as an expense by the partnership nor can it be deducted from the partner's distributive share. In addition, California applies an income fee ranging from \$900 to \$11,790 based on total annual income to every LLC treated as a partnership for tax purposes.

Arizona is one of five states among the 10 comparison states to apply a minimum S-corporate income or similar tax such as franchise, business and occupation, net worth, or excise tax. Arizona currently only applies the minimum tax if the S-corporation is subject to the federal income tax. The other four states apply their minimum tax regardless if the S-corporation is subject to the federal income tax. The five states to impose a minimum tax are Arizona, California, Georgia, New Mexico, and Oregon of \$50, \$800, \$10, \$50, and \$10, respectively. Georgia's minimum net worth tax is a graduated rate of \$10 to \$5,000.

**C. Volatility**

The level of revenue raised by the partnership and expanded S-corporation minimum tax is only mildly volatile as it is subject less on economic swings or net profits and more on other business climate factors. It is based on the number of entities subject to filing a return. The revenue related to the partnership and S-corporation filings should be more consistent and less volatile.

## **D. Simplicity**

We believe the application of the partnership and S-corporate minimum tax is simple and straightforward. Existing technology with some modifications can be used to administer the tax.

No additional calculations or determinations are required. The tax due can be reported on the annual tax return filing. The remittance process would likely be by check and can be collected similar to the regular corporate minimum tax.

## **6. Economic Impact:**

For the 2000 tax year, there were about 47,000 partnership returns, Form 165, filed. In the same year, 50,973 S-corporate returns, Form 120S, were filed without the minimum tax. As a comparison, the total number of S-corporation returns, Form 120S filed for 1998 and 1999 were 42,587 and 46,163, respectfully.

The following chart presents the projected annual revenue should a minimum tax of \$50, \$100 or \$200 be applied based on 2000 filing results. The tax rates were selected as a competitive comparison to the other states and do not represent any relationship to the cost of administering the returns.

Return Type	Returns w/ Expanded Minimum Tax	Total Returns	Percent w/ Expanded Minimum Tax	\$50 Minimum Tax Revenue	\$100 Minimum Tax Revenue	\$200 Minimum Tax Revenue
Ptrsp	47,000	47,000	100%	\$2,350,000	\$4,700,000	\$9,400,000
S-Corp	<u>50,973</u>	<u>50,973</u>	<u>100%</u>	<u>\$2,548,650</u>	<u>\$5,097,300</u>	<u>\$10,194,600</u>
Totals	97,973	97,973	100%	\$4,898,650	\$9,797,300	\$19,594,600

## **7. Other:**

Arguments of applying the minimum (annual) tax to partnership and S-corporations are the following:

- It will require only a few changes to the existing filing process.
- It is simple to apply and administer, and for taxpayers to comply.
- It will offset administrative costs of the income tax return filings.

Arguments against applying the minimum (annual) tax to partnership and S-corporations are as follows:

- The minimum tax for S-corporations would exceed or equal all comparison states except for California.
- The minimum tax for partnerships does not exist in the comparison states except for California.
- The tax is applied to pass-through entities and will affect other tax revenue sources.
- The tax is regressive. A minimum tax may be punitive to small businesses, loss and inactive entities.
- The tax creates double taxation on pass-through entities.